A8525-1
4/14/89

SIA SECURITIES INDUSTRY ASSOCIATION

TRENDS

An Analysis of Emerging Trends in the Securities Industry

Produced by the SIA Research Department

Vol. XV, No. 3 April 14, 1989

OBSERVATIONS ON THE REGIONAL FIRM

The past 18 months have presented memorable challenges to the securities industry and particularly to regional and local firms, which focus so importantly on the retail business. This issue of Trends highlights key shifts in business and performance patterns for the securities industry and for regional firms.1/

This overview of the past performance of regional firms and challenges for their future is approached in four parts:

- o Performance of the securities industry
- o Performance of regional firms
- o Regionals' performance vs. national firms
- o Key questions on the business approach of regional firms

1/ Based on a presentation by Edward I. O'Brien at SIA's April, 1989 Regional Conference in Chicago. SIA welcomes contributions to Trends from all sources, from member firms as well as others, relating to the securities industry and capital markets. Please send submissions to the attention of Jeff Schaefer or George Monahan, SIA Research Department.

ANNUAL SUBSCRIPTION
$60.00 members • $96.00 non-members

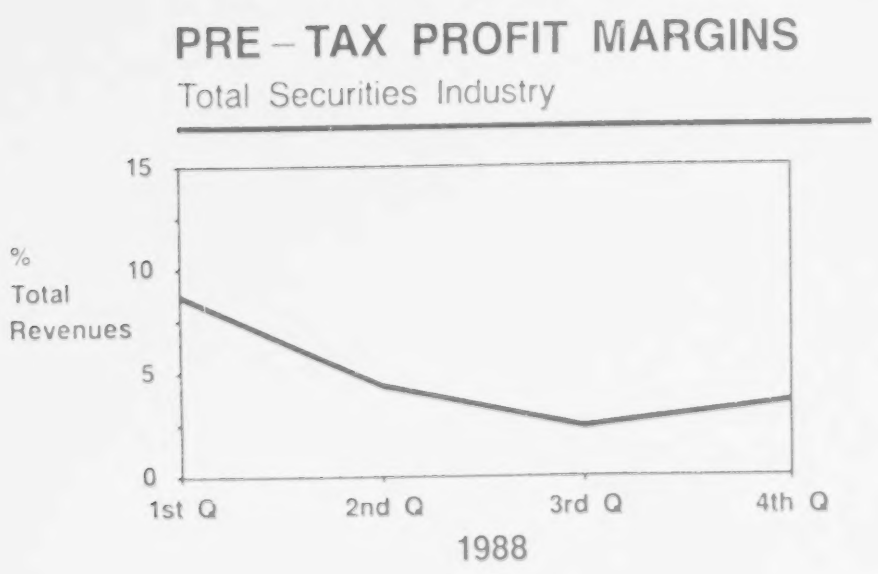
Securities Industry Association • 120 Broadway, New York, N.Y. 10271 212•608•1500

SECURITIES INDUSTRY PERFORMANCE

The past 18 months have presented memorable challenges to the securities industry and particularly to regional and local firms, which focus so importantly on the retail business. But the securities business is a cyclical business and so it will improve. In fact, preliminary indications show that the first quarter of this year produced somewhat improved results. Today, therefore, seems like a particularly good time to pause and reflect on where the securities industry stands today, upon the nature of securities and regional firms, the markets they serve and, most importantly, whether today's approaches are the best they can be in the competitive and changing environment the industry faces.

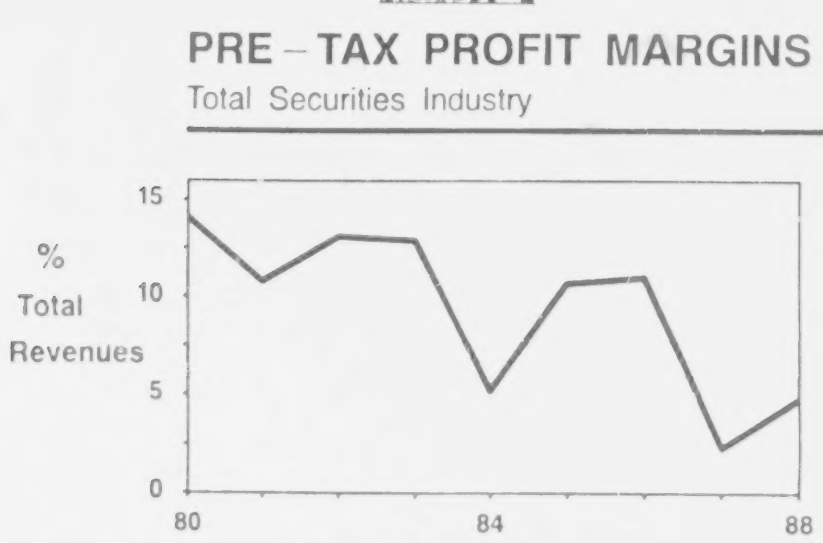
On the whole, retail profitability in regionals has not been satisfactory for at least the period since October, 1987. In fact, the profitability of the securities industry itself, both retail and institutional, large and small, has also been unsatisfactory. Fortunately, as **Exhibit 1** shows, the industry as a whole has finally had an up quarter, producing a 1988 fourth quarter pre-tax profit margin of 3.6%. These results are, of course, far below long-term or satisfactory levels.

EXHIBIT 1



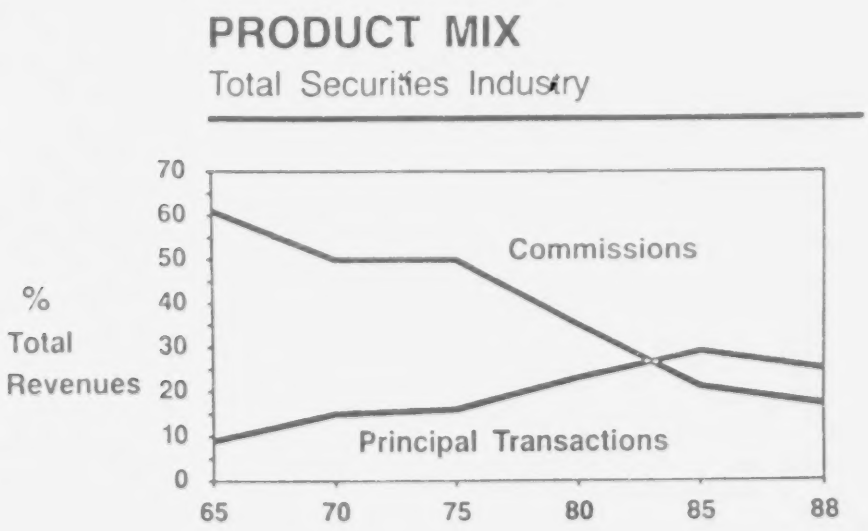
The nine-year snapshot of pre-tax profit margins for the securities industry in Exhibit 2 shows the marked deterioration from the profitability levels early in this decade. As can be seen, we've come from 14.1% in 1980 to 4.8% for all of 1988. Nonetheless, perhaps the gloom is beginning to lift.

EXHIBIT 2



The long-term industry trend away from the commission business continues. Exhibit 3 shows that industry commissions fell from 60% of industry revenues in 1965 to 17% last year. Conversely, principal transactions, defined as trading and investment gains, rose from less than 10% of revenues in 1965 to a peak of around 30% in 1985 and about 25% last year. If the investment banking-generated revenues, such as M & A, private placements and underwritings are added to principal transactions, it accounts for over 60% of industry revenue last year.

EXHIBIT 3



Looking at the quarterly performance of regional firms last year, **Exhibit 4**, shows that the first quarter 1988 pre-tax profit margin of 4.1% declined to 1.3% in the fourth quarter...not a pretty sight. As mentioned earlier, however, preliminary indications are for improved results among regionals in the first quarter of this year. Still, it is clear 1988 was a very tough year for regional firms.

EXHIBIT 4

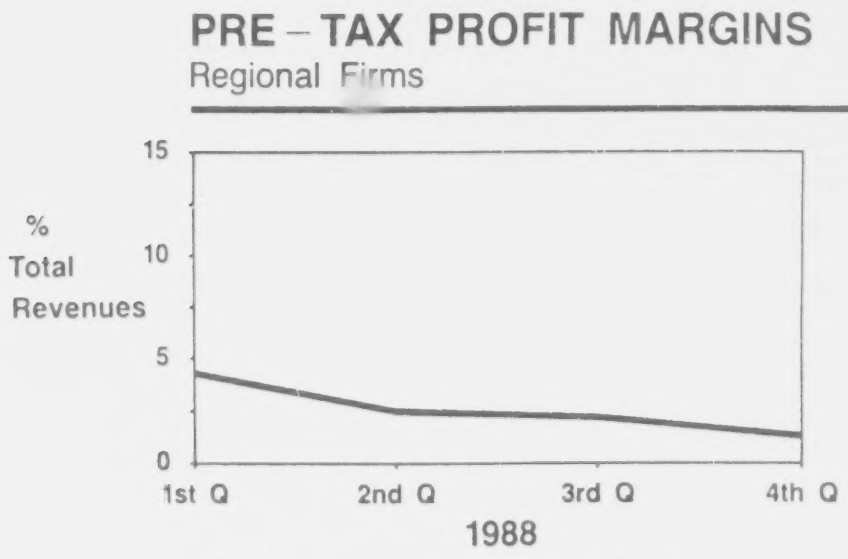
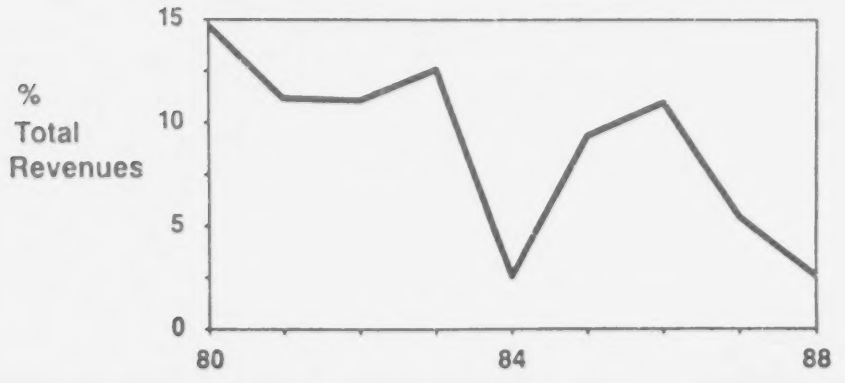


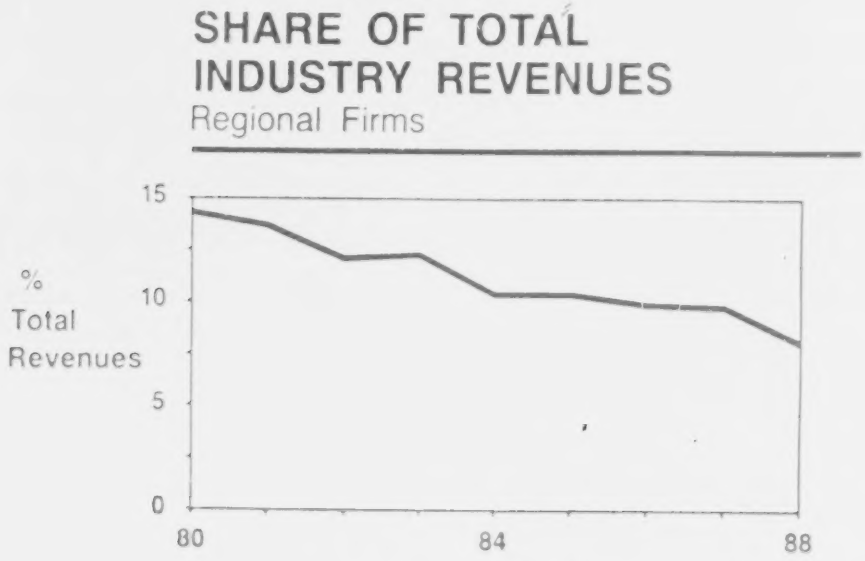
Exhibit 5 highlights the profit performance of regional firms over the 80s. In 1980, regional firms as a group had a pre-tax profit margin of 14.7%. For 1988, it was only 2.6%. The cyclicality that distinguishes the securities industry is clear and thus future results will undoubtedly get better. Nonetheless, the trend here is troublesome which raises a fundamental question: "Are there changes occurring in the markets that regional firms serve that call for new approaches?"

EXHIBIT 5



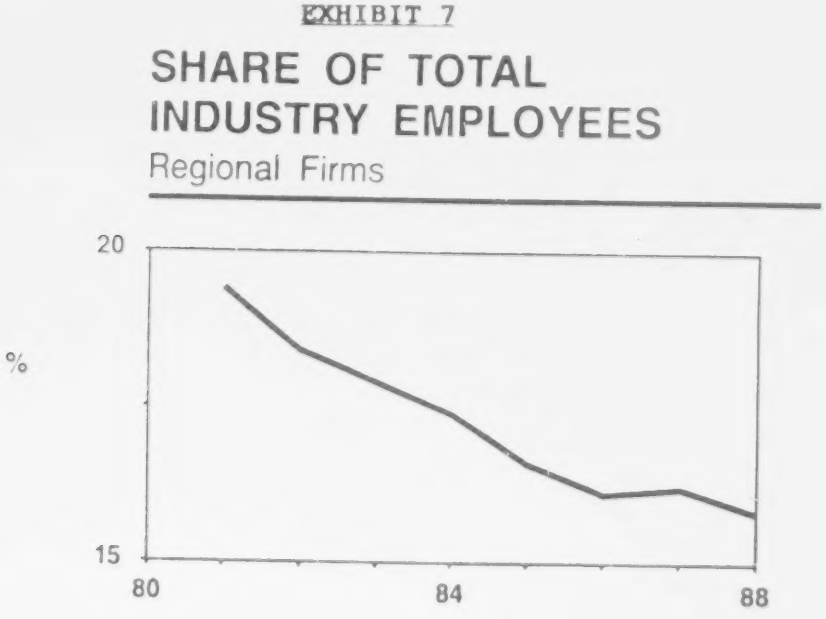
The consolidation and concentration that has taken place in the securities industry is a familiar story to all. **Exhibit 6** graphicly depicts the decrease in total industry revenues attributed to regional firms during this decade.

EXHIBIT 6



Employee counts provide another measure of the same trend. Looking at regional firms' share of industry employees in **Exhibit 7** also emphasizes this consolidation.

EXHIBIT 7



Although regional firms' share of industry employment, revenues, etc., has fallen, this does not mean that regional firms themselves are smaller. For instance, based on SIA's membership as published in SIA's 1980 yearbook, out of the top 100 regional firms (defined in the yearbook as being headquartered outside New York City and not to be confused with the SIA/SEC/NYSE "regional" category used throughout the rest of this analysis), only two had capital above $45,000,000 -- in 1988, 31 did.

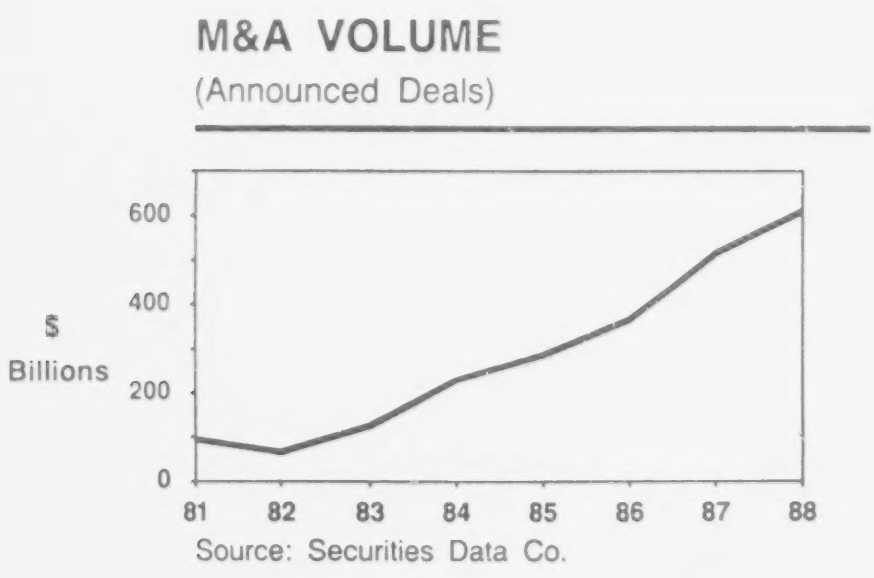
One more statistic from comparison of these two yearbooks which best sums up the intense competition in which regional firms engage: 40 of the top 100 regional firms in 1980 are gone from the current list!

The main point is though the regional segment of the industry is growing in absolute dollar terms, there has also been consolidation and regionals now make up a smaller portion of the total securities industry. This reflects two primary facts:

- o Consolidation among regional firms;
- o The retail business, which dominates the business of regional firms as a group, has grown more slowly than other lines of activity.

One example of the fantastic growth in a non-retail business line, one in which regional firms have not been important participants, is M&A activity. Exhibit 8 shows announced M&A activity has increased more than six-fold in six years!

EXHIBIT 8

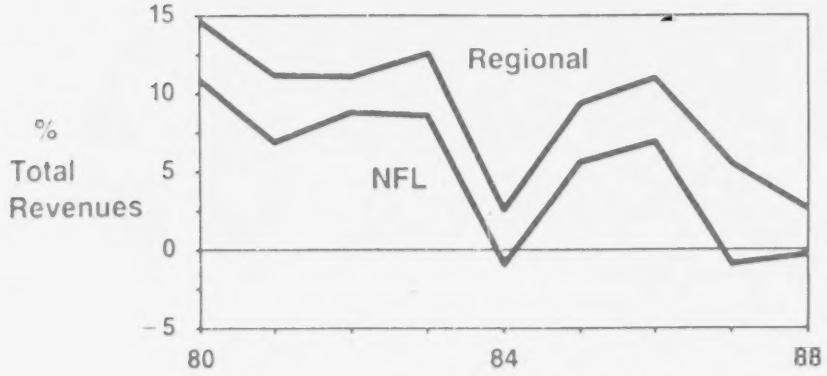


But lest one feels there is only bad news in regional firms' performance, let us look at how their performance stacks up against another segment of our industry, the national full line firms.

As **Exhibit 9** shows, regional firms have consistently outperformed the national full line firms, the very firms many regional firms consider their main competitors. So, with all the difficulties of regionals' main business, they still manage to outperform their primary competitors.

EXHIBIT 9

PRE-TAX PROFIT MARGINS



As an aside, some of the strong points of regional firms stems from their smaller size. A smaller size seems to permit closer personal relationships; there are fewer layers of management; people seem to know each other better, and they seem to take a longer term view of the business.

The theme of SIA's 1989 Regional Conference was "Retail Profitability: Opportunity or Oxymoron?" This title, itself, raises a critical question for regional firms. In a sense, most regional firms have really bet their business on the individual investor. This has long served them well. However, today's environment should raise a series of questions about firms' business strategy. Are the assumptions which have been made correct, or are things changing in a significant and different way?

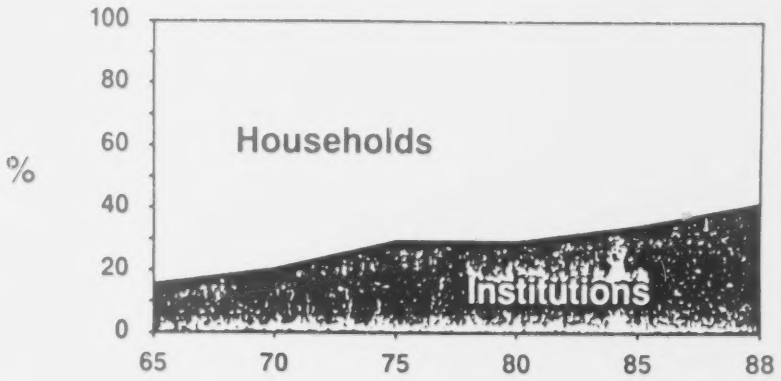
Also, there seems to be a growing distinctiveness among the more successful regional firms. In the past, the label "regional firm" conjured up a very specific firm and way of doing business. Now it seems firms are formulating very different ways of addressing the retail market. In the course of this program, you'll be hearing from some good illustrations of this point. Edward D. Jones, Piper Jaffray, Alex. Brown, Legg Mason and Raymond James, to name a few, certainly are

distinguishing themselves in quite different ways in the retail business. One major question each regional firm should ask itself is: "Is your retail strategy a winning one?"

The institutionalization of our markets has received much comment. Today, institutions own 40% of U.S. equities (Exhibit 10) and account for a much higher proportion of total trading activity of these shares. Although this obviously is not a proxy for the retail market as a whole, it still makes one want to understand more of exactly what is going on among current and potential individual customers, it argues for a fresh look at retail strategies, at diversification. Or, in other words, "Is retail enough for regional firms' success?"

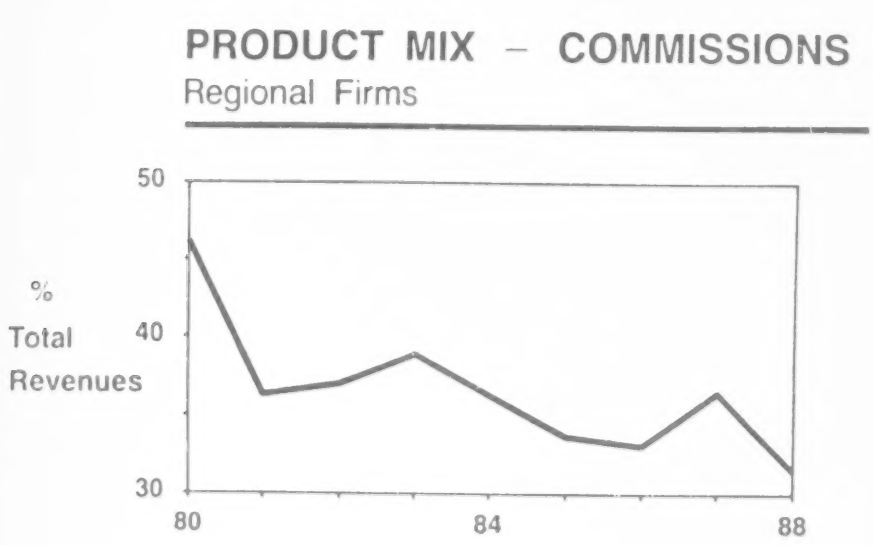
EXHIBIT 10

HOLDINGS OF U.S. EQUITIES



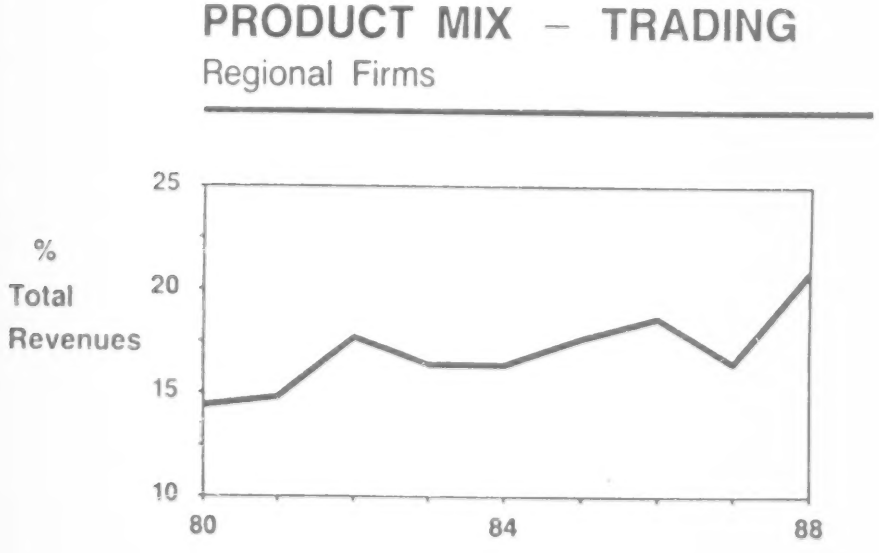
Let's now turn back to the regional firm business performance. While commission business at regional firms has declined along with industry trends, it still accounts for over 30% of regional firm revenues (**Exhibit 11**) and is still regional firms' #1 source of revenues; 31 1/2% for 1988. Another question: Has October 19 produced a temporary or a more durable drop here?

EXHIBIT 11



Regionals have participated in the trend toward principal business. The surge in 1988 (to 20.9% of total regional firm revenues, **Exhibit 12**) reflects the interest of customers in fixed income securities. Again, is this shift a temporary reaction or a new retail fact of life?

EXHIBIT 12

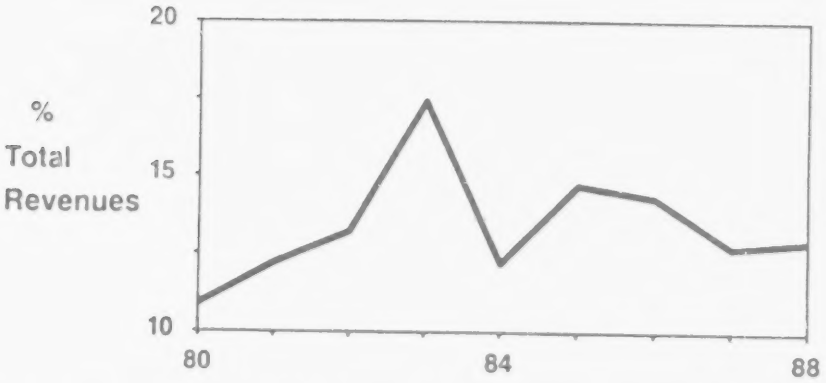


As is well know, underwriting has experienced radical changes during the 1980s. Rule 415 and legislative changes concerning municipal bonds are but two examples where important sources of business for regional firms have been adversely impacted. This has led to increased domination by the largest firms and growing challenges for regionals. Nonetheless, regional firms have been holding their own and generated 12.9% of your total 1988 revenues through underwriting (**Exhibit 13**).

EXHIBIT 13

PRODUCT MIX – UNDERWRITING

Regional Firms

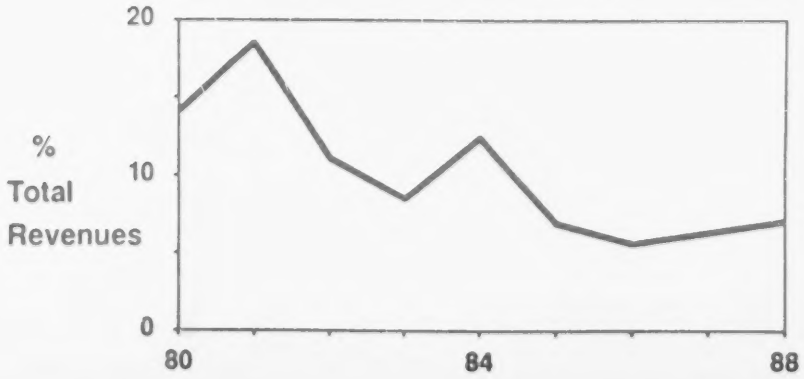


Not too many years ago, interest profits associated with free credit balances and margin loans provided a major source of profits from the retail business. Money market funds and sweep accounts have produced significant changes in the economics of the retail business. Nonetheless, interest profits are still an important factor to the retail business, albeit less than in the past. Although profit figures from this source are not tracked, revenues from margin interest are shown in **Exhibit 14**.

EXHIBIT 14

PRODUCT MIX – MARGIN INTEREST

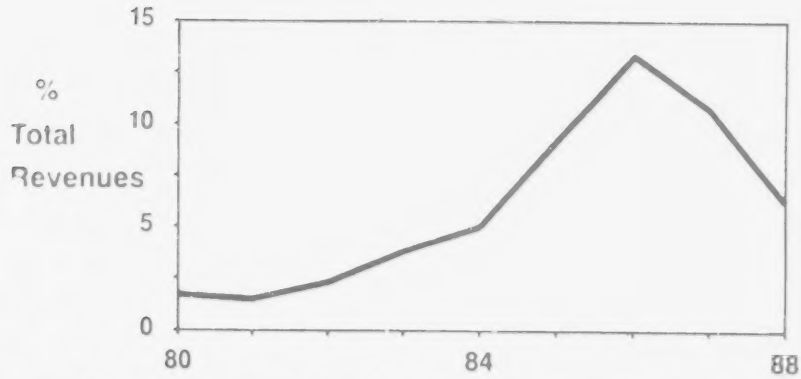
Regional Firms



Mutual funds have been one of the big success stories for regional firms, climbing from 1.7% of their revenues in 1980 to a high of 13.3% in 1986; however, since then it has fallen back down to 6.2% last year (**Exhibit 15**). Again, the question of exactly what the long-term impact of October 19 will be needs to be examined. Chances are, due to their popular success, that mutual fund sales will come back strongly in the next up cycle.

EXHIBIT 15

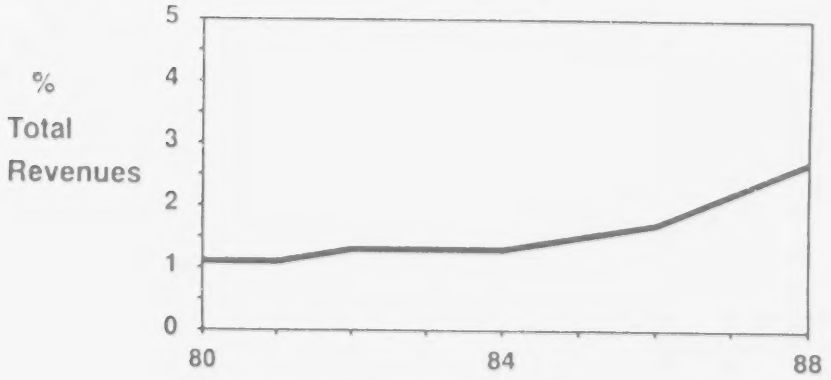
PRODUCT MIX – MUTUAL FUNDS
Regional Firms



Although still relatively small compared to other business lines, fees (from account supervision and management) represent an area of important progress for regional firms and, some argue, important potential. From 1.7% of regional firms' revenues in 1980, fees have grown gradually but steadily to 2.7% last year, and that's on a higher revenue base (**Exhibit 16**).

EXHIBIT 16

PRODUCT MIX – FEES
Regional Firms



These have been some of the highlights of regional firms' revenue picture. In sum, regional firms have been primarily committed to the retail business, which has been in a slump for the past 18 months. More significantly, there appear to be various significant changes in the retail business that have made it more difficult to be profitable, including the loss of interest profit via free credit balances, legislative changes affecting the municipal business, and growing domination of underwriting by large firms. In short, the retail game is changing. But a main question remains: are regional firms also changing to meet these changes?

What about expenses? Well over half of the regional firms' expenses are people. The formulas utilized to compensate brokers proved very effective last year in quickly and dramatically producing cost reductions. Aggregate regional firm revenues dropped 15.3% last year from 1987. As shown in **Exhibit 17**, RR compensation dropped from 28.3% of regionals' revenues in 1987 to 25.2% in 1988. From a profitability standpoint, that was a stellar performance. Of course, this also means the firms' most important strength, its brokers, are hurting.

EXHIBIT 17

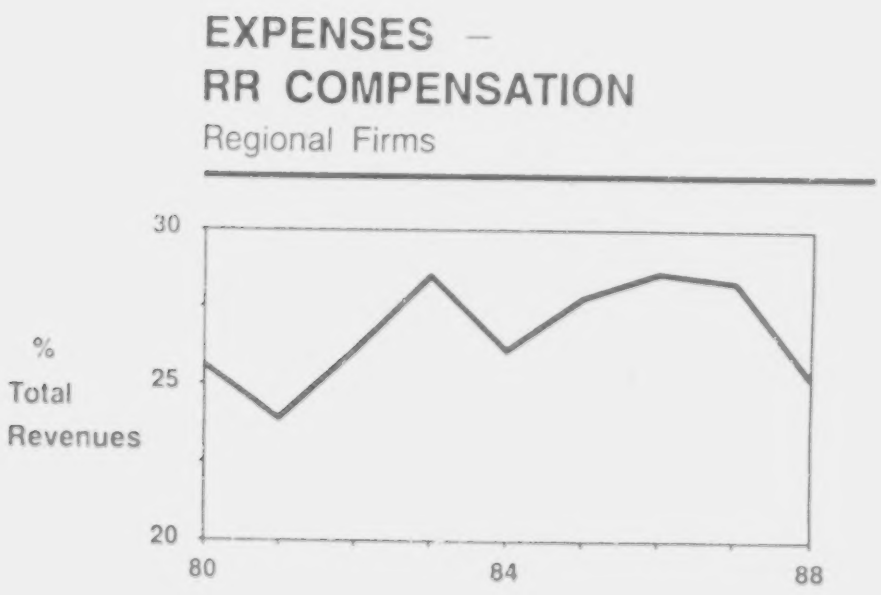


Exhibit 18 shows a disturbing trend in the so-called fixed portions of compensation, paid to clerical and administrative personnel; that is, all non-producing people. While the broker compensation formulas, once in place, automatically flex with revenues, this category of compensation is changed only through management intervention. Most importantly, of course, this involves controlling staff levels. In the past year, that has meant layoffs. Note that 1988 costs in this area, at 29 1/2% of total revenues, consumed a full 5 percentage points more of revenues then in 1980.

EXHIBIT 18

EXPENSES – NON – RR COMPENSATION

Regional Firms

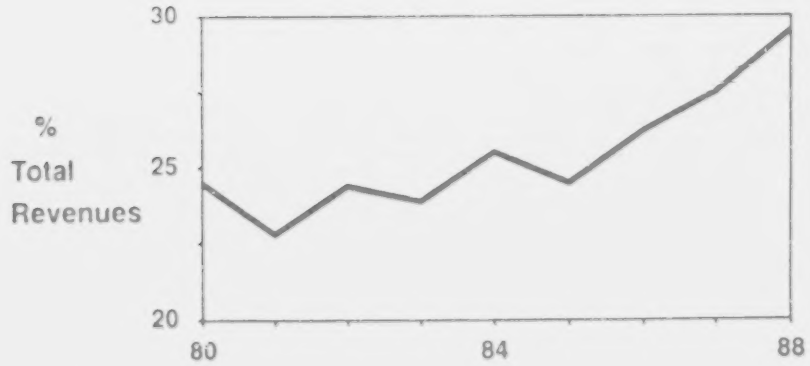
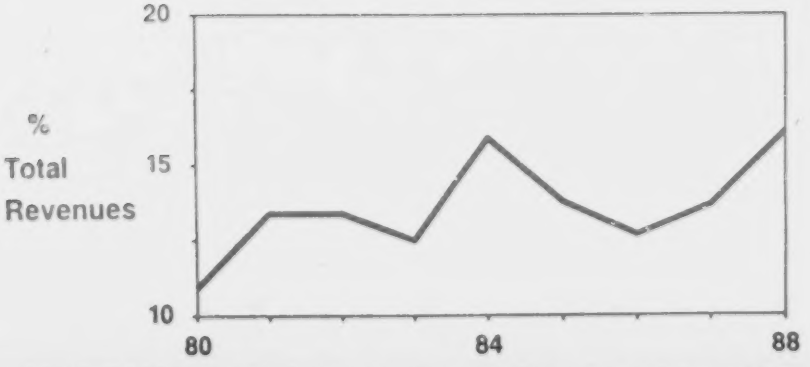


Exhibit 19 illustrates a problem which all securities firm management is very familiar with: coping with fixed costs in a cyclical business. Combining communications, occupancy and data processing costs,, the 1988 percentage of total regional revenues is 16.1%, which is more than 5 points above what it was in 1980. Many regional firms have leaned toward fixed costs via self-clearing, in-house data processing and so forth. Perhaps it's time, at least for some, to reexamine this whole area.

EXHIBIT 19

EXPENSES – COMMUNICATIONS/ OCCUPANCY/DATA PROCESSING

Regional Firms



Productivity is a crucial issue for securities firms. **Exhibit 20** shows figures from SIAs annual surveys of RR production. As can be readily seen, there is evidence that regional firms are losing ground to the nationals in terms of the average gross production of their RRs. The classical scenario was that regional brokers produce less, but were paid at higher percentage rates, resulting in W-2 compensation that was roughly equivalent to that of their national competitors. Similarly, the regionals were said to spend more on direct compensation and less on sales support. Are these concepts still valid?

EXHIBIT 20

RETAIL RR PRODUCTIVITY

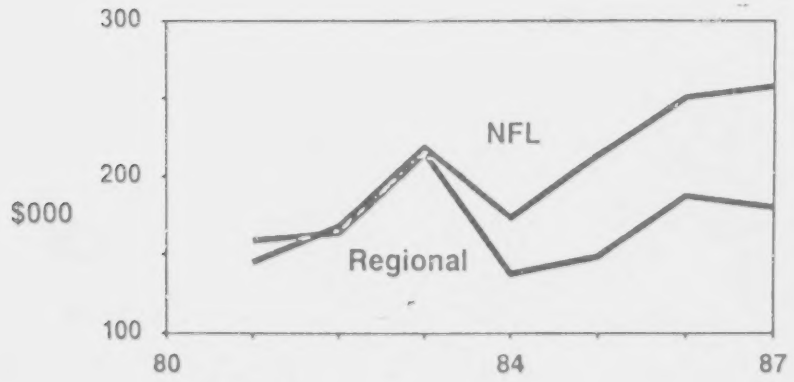
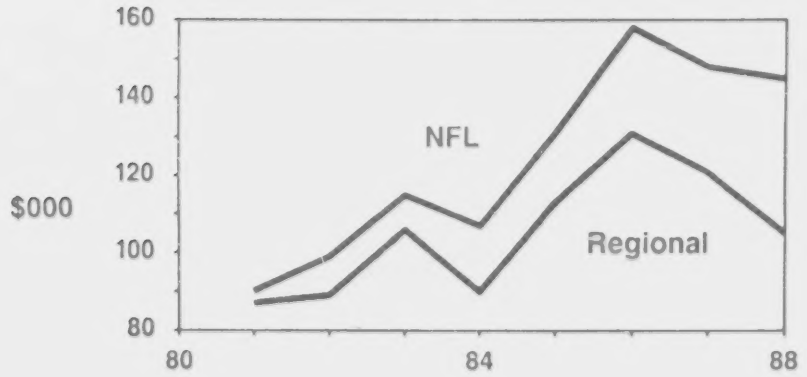


Exhibit 21 takes another look at a comparison of regional and national firm productivity, in this case using total revenues per employee. The concern it raises is the apparent widening of these measures.

EXHIBIT 21

REVENUES/EMPLOYEE



The purpose of these observations is to focus more on the questions than on answers. The answers will be different from firm to firm. It is also crucial to test long held assumptions. Over time, habits of doing things creep into our thinking. Those assumptions may no longer be valid. And if relied upon, they can lead to the wrong conclusions.

Mentioned earlier were five different firms with five different approaches to the retail market and to this industry. They were mentioned to make a point. And it is this:

Aside from all else, the key to success in this business is uniqueness. The ability, in fact the courage, to carve out your own way of looking at things and, based on your own culture, to be different. Two other questions suggest themselves:

- Is the securities industry in cyclical decline, entering a long-term down period?

- Are there any basic rules of the road which should be kept in mind?

As to the first question, the answer is, **No!** The securities industry is not entering a time of decline, despite the increased competitiveness and lower margins. Why? There are two reasons.

1. The American and the worldwide society have entered an era of "financial regeneration and awareness." People, governments, and the public perception is that financial management can contribute to a better life and play a part in alleviating the needs of people around the globe.

2. The securities industry has the experience and the means to play a central, in fact a critical, role in the advancement of the goals of this worldwide phenomenon.

So we have a demonstrated need and the means to advance that need.

As to the second question, there are three basic rules of the road, simple Yes! Somewhat pedestrian Yes! But nevertheless, they have stood the test of time and travail:

1. The number #1 rule for any business is to have a vision or a goal for the firm. The five firms mentioned have it. They have decided what they want to be, where they want to go, and how to get there. As Alice in Wonderland said, if you don't know where you want to go, it doesn't really matter which road you take to get there. But we know that usually leads to catastrophe.

2. The second inviolate rule can be called many things, but let's call it "client" preoccupation. You need to know, really know, what the client wants or needs, and be preoccupied in doing just what he wants or needs. And this applies to any client of any size, no matter whether it's an individual, an entrepreneur, a government, a corporate client, or an institution.

3. The last rule revolves around the first two, and it is the profit rule. In business, you must understand fully, and have the entire organization understand it, that you expect to earn a respectable profit from your vision and from your service. That means cost consciousness across the board for all services, for clerical, sales, marketing and management. There is no substitute for it. And coupled with vision and service, it works!

Edward I. O'Brien
President
Securities Industry Association